

05-1126

AUDIT

TAX YEARS: 2004, 2005, 2006

SIGNED: 05-29-08

COMMISSIONERS: P. HENDRICKSON, R. JOHNSON, M. JOHNSON, D. DIXON

GUIDING DECISION

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BEFORE THE UTAH STATE TAX COMMISSION

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PETITIONER,	<b>FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL DECISION</b>
Petitioner,	
v.	Appeal No. 05-1126
AUDITING DIVISION OF THE	Account No. #####
UTAH STATE TAX COMMISSION,	Tax Type: Corporate Franchise
Respondent.	Tax Years: 2004, 2005 & 2006
	Judge: Chapman

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**Presiding:**

R. Bruce Johnson, Commissioner

Marc B. Johnson, Commissioner

Kerry R. Chapman, Administrative Law Judge

**Appearances:**

For Petitioner: PETITIONER REP 1, Attorney  
PETITIONER REP 2

For Respondent: RESPONDENT REP 1, Assistant Attorney General  
RESPONDENT REP 2, from the Multi-State Tax Commission  
RESPONDENT REP 3, from the Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on February 26, 2008. At the hearing, the taxpayer referred to an article by PERSON A, which it submitted on February 27, 2008. Based upon the evidence and testimony presented, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. The tax at issue is corporate franchise tax.

2. The tax years at issue are 2004, 2005 and 2006.<sup>1</sup>

3. On May 17, 2005, the taxpayer, PETITIONER. (“PETITIONER”), submitted a letter to the Commission in which it requested permission “to file under separate accounting to cure Utah Corporate Franchise Tax distortion resulting from PETITIONER operations in the State of Utah.”

4. On July 7, 2005, Auditing Division (“Division”) responded to PETITIONER and denied its “request to deviate from the UDITPA<sup>2</sup> three-factor formula in filing Utah corporate franchise tax returns.” In its letter, the Division informed the taxpayer that it could appeal its decision.

5. On August 5, 2005, the taxpayer filed a Petition for Redetermination with the Commission in which it asked to be allowed to use separate accounting “for the period of time that the company is establishing its presence in the State.”

6. On January 18, 2006, the Commission issued an order in which it ruled that it would address this matter through the adjudicative hearing process instead of through a declaratory proceeding.

7. On February 5, 2008, the taxpayer submitted an Amended Petition for Redetermination, in which it requested a refund of \$\$\$\$ in tax, plus interest, for tax years 2004, 2005 and 2006. In the amended petition, the taxpayer asserted that it was abandoning its previous request for separate accounting and now requesting to apply an alternative apportionment formula pursuant to Utah Code Ann. §59-7-320.

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1 PETITIONER stated in its Amended Petition for Redetermination that the years at issue are 2004, 2005 and 2006, which is supported by information shown on the Alternative Apportionment Tax Calculations that PETITIONER submitted in Exhibit P-2 at p. 1. Information in Exhibits P-2 and P-3 shows that PETITIONER fiscal years end on January 31<sup>st</sup> of each year. For example, the 2004 tax year begins on February 1, 2004 and ends on January 31, 2005.

2 “UDITPA” refers to the Uniform Division of Income for Tax Purposes Act.

Taxpayer's Information and Arguments

8. PETITIONER operates department stores throughout the United States, including Utah.

9. PETITIONER expanded to Utah by opening five new stores within the state in October 2004.

10. Exhibit R-6 shows the number of PETITIONER stores that existed in each state for each fiscal year ending ("FYE") between January 1994 and January 2006. The exhibit shows that PETITIONER has been increasing its total number of stores each year since 1994. It also shows that PETITIONER expanded into three "new" states during FYE January 2004, into three new states (including Utah) during FYE January 2005, and into one new state during FYE January 2006.

11. PETITIONER claims that during the first few years of a new store's operations, the store incurs significant costs related to pre-opening expenses that are not incurred by a more mature store. Pre-opening costs include advertising and training costs.<sup>3</sup> Furthermore, PETITIONER claims that a new store's sales are lower than those of a more mature store. For these reasons, PETITIONER claims that its Utah stores generated less income per store than its other stores for the years at issue.

12. Utah's UDITPA provisions apportion a taxpayer's total business income by weighting the sales factor, the property factor, and the payroll factor ("three factors") equally.<sup>4</sup> PETITIONER argues that this "straight average" does not strongly correlate to the actual profits earned in a state, especially where a company has recently opened new stores in a new market. For these reasons, PETITIONER contends that

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<sup>3</sup> PETITIONER REP 2 initially testified that PETITIONER incurred pre-opening expenses of approximately \$\$\$\$ for property and other expenses, such as advertising. Later, he testified that he believed the \$\$\$\$ million in pre-opening costs did not include the cost of the stores.

<sup>4</sup> In recent years, Utah Code Ann. §59-7-311 was revised to allow a taxpayer to "double-count" the sales factor in Utah's UDITPA methodology for tax years beginning on or after January 1, 2006.

apportioning its business income using a straight average of the three factors distorts the income assigned to Utah for the 2004, 2005 and 2006 tax years. To rectify this distortion, PETITIONER asserts that adjustments should be made to Utah's UDITPA allocation method, as authorized under Utah Code Ann. §59-7-320. Otherwise, PETITIONER argues, the amount of income assessed by Utah violates the United States and Utah Constitutions.

13. PETITIONER states that a departure from UDITPA was anticipated by PERSON A, one of UDITPA's original proponents, in cases where the methodology results in "individualized injustice." PETITIONER points out that Section 59-7-320, which provides for "equitable adjustment" under certain circumstances, was included in Utah's UDITPA provisions to prevent such injustices. PETITIONER also states that courts have allowed departures from UDITPA where "reasonableness" requires such action. Because of PETITIONER unique circumstances during its first three years in Utah, PETITIONER contends that reasonableness requires the Commission to accept its proposed adjustments in order to avoid injustice.

14. To further support its argument, PETITIONER asserts that UDITPA is a "mass appraisal" tool that can be compared to the mass appraisal assessments produced for property tax purposes. Much like a property tax assessment has the assumption of correctness until shown otherwise, PETITIONER asserts that a corporate franchise taxpayer should be allowed to depart from UDITPA whenever it shows that a "fairer" method of taxation exists. Moreover, PETITIONER states that recent history has shown a higher willingness among states to depart from UDITPA because many states, including Utah, now allow the sales factor to be emphasized in their respective UDITPA methodologies.

15. PETITIONER submitted a "Tax Model" to identify how it believes the sales, payroll and property factors should be weighted in order to more fairly tax its profitability (Exhibit P-1). The Tax Model is based on a regression equation. PETITIONER asserts that the Tax Model shows that increased sales are related to increased profits, while increased payroll and property are both related to decreased profits. As a

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result, PETITIONER asserts that the three factors should not be weighted equally in accordance with the UDITPA methodology, but as follows:

	<b>UDITPA Weighting Coefficient</b>	<b>PETITIONER Tax Model Weighting Coefficient</b>
Sales Factor:	XXXXXX	XXXXXX
Payroll Factor:	XXXXXX	XXXXXX
Property Factor:	XXXXXX	XXXXXX

16. PETITIONER REP 2 testified on behalf of PETITIONER. PETITIONER REP 2 stated that he did not participate in the preparation of the Tax Model, but is familiar with regression methodology based on his study of statistics in obtaining his JD and MBA degrees. He testified that the Tax Model was prepared by a former PETITIONER employee who has a doctorate in statistics. He also explained that the model was produced with the goal of identifying company profit by state based on the sales, payroll and property factors.

17. PETITIONER REP 2 testified that the quality of the Tax Model is high, as evidenced by statistical tests that PETITIONER ran on it. PETITIONER REP 2 pointed out that PETITIONER derived an R-Square of XXXXXX, an F Value of XXXXXX, and a Variable Inflation Factor of XXXXXX for the Tax Model (Exhibit P-1 at pp. 4-6). PETITIONER REP 2 stated that a “perfect” R-Square would be 1.00. Because PETITIONER information shows that Utah’s UDITPA methodology results in an R-Square of XXXXXX and the Tax Model results in an R-Square of XXXXXX, PETITIONER REP 2 contends that the Tax Model is a better indicator of profit than UDITPA.

18. The Tax Model was prepared with operating profit, sales, payroll and property data from all existing PETITIONER stores (Exhibit P-1 at p. 9). PETITIONER REP 2 testified that data used in the Tax Model is found in Exhibit P-3, which is identified as PETITIONER “Schedule of Operating Profit, Sales, Property & Payroll For the Fiscal Year Ended 2-3-07.” Exhibit P-3 includes data from six Utah stores, in

addition to data from PETITIONER other stores. Three of the Utah stores had “operating income” in excess of \$\$\$\$\$, while the other three had operating income that ranged between \$\$\$\$\$ and \$\$\$\$\$. These operating incomes of the Utah stores are similar to those of a significant number of PETITIONER other stores. Furthermore, all ( X ) of the Utah stores showed sales that ranged between \$\$\$\$\$ and \$\$\$\$\$, similar to the sales shown for a significant number of PETITIONER other stores.

19. PETITIONER also departed from Utah’s UDITPA laws when determining the sales, payroll and property factors to which it applied its Tax Model weighting coefficients. Under UDITPA, the three factors are determined by applying the taxpayer’s Utah sales, payroll and property amounts to its total sales, property and payroll amounts, respectively. PETITIONER determined its sales factor by adding to its Utah sales an allocated portion of its e-commerce sales that occurred outside of Utah. Similarly, it allocated to Utah a portion of its payroll incurred at and property existing at its corporate headquarters and distribution centers, which are located outside of Utah. Exhibit P-2 at pp. 2-4.

20. PETITIONER also calculated sales, payroll and property factors using Utah’s UDITPA laws. Exhibit P-2 at p. 5. PETITIONER REP 2 stated, however, that he was not familiar with how PETITIONER arrived at these calculations. Nevertheless, using the three UDITPA factors it calculated and its proposed weighting coefficients and adjusted factors, PETITIONER determined the percentage of its total income that would be apportioned to Utah under both methods, as follows (Exhibit P-2):

<b>Tax Year</b>	<b>UDITPA - % of Income Apportioned to Utah</b>	<b>PETITIONER Proposal - % of Income Apportioned to Utah</b>
2004	XXXXX	XXXXX
2005	XXXXX	XXXXX
2006	XXXXX <sup>5</sup>	XXXXX

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5 This apportionment percentage was determined by double-counting the sales factor, as allowed under Section 59-7-311(2),(3) for tax years beginning on or after January 1, 2006.

21. Using the apportionment percentages found in the paragraph above, PETITIONER calculated the amount of Utah corporate franchise tax due under both methods, as follows (Exhibit P-2 at p.1):

	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>Total</b>
Utah's UDITPA Method	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$
PETITIONER Proposed Method	<u>\$\$\$\$\$</u>	<u>\$\$\$\$\$</u>	<u>\$\$\$\$\$</u>	<u>\$\$\$\$\$</u>
Difference in Utah Tax	<u>\$\$\$\$\$</u>	<u>\$\$\$\$\$</u>	<u>\$\$\$\$\$</u>	<u>\$\$\$\$\$</u>

22. Based on these tax calculations, PETITIONER asks the Commission to refund \$\$\$\$\$ in tax. PETITIONER REP 2 testified that if the Commission rejects PETITIONER proposed model and declines to issue a refund, PETITIONER tax liability will be distorted by %%%% for the three years at issue.<sup>6</sup> PETITIONER REP 2 stated that courts have found such a distortion to be unconstitutional.

23. PETITIONER REP 2 admitted that PETITIONER Tax Model was not being used nationwide by all other states. However, PETITIONER REP 2 testified that PETITIONER personnel told him that PETITIONER was taxed on ( X ) percent or more of its income nationwide. Even if PETITIONER was currently taxed on exactly one hundred percent of its income nationwide, PETITIONER REP 2 stated that Utah's acceptance of PETITIONER proposed tax model would result in PETITIONER still being taxed on more than ninety-nine percent of its income. PETITIONER REP 2 stated that such taxation would meet the "reasonable" test imposed by courts.

24. Finally, PETITIONER argued that uniformity between states no longer seems to be a goal, as many states have departed from UDITPA. For these reasons, it argued that a goal of one hundred percent taxation no longer occurs. For these reasons, PETITIONER asks the Commission to impose its

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<sup>6</sup> %%%% is the percent obtained by dividing the \$\$\$\$\$ of tax liability derived from Utah's UDITPA laws for the three years at issue by the \$\$\$\$\$ of tax liability derived from PETITIONER proposed methodology.

corporate franchise tax on the most accurate determination of PETITIONER income in Utah, which it purports is shown by its Tax Model.

Division's Information and Arguments

25. The Division asks the Commission to reject PETITIONER proposed adjustments to Utah's UDITPA methodology for the years at issue and, as a result, to reject its refund request.

26. The Division argued that the purposes of the Multistate Tax Compact ("Compact") of which Utah is a member include the equitable apportionment of tax bases, uniformity, taxpayer convenience, and the avoidance of duplicative taxation (Utah Code Ann. §59-1-801, Article I). The Division asserted that PETITIONER proposed adjustments do not comport with the stated purposes of the Compact.

27. In addition, the Division argued that UDITPA's three-factor method to apportion business income is a "benchmark" that has been supported by various courts. It asserted that courts have determined that the purpose of the UDITPA methodology is to "approximate" income and that courts have deemed a "rough approximation" to be adequate.

28. The Division also pointed out that most taxpayers could demonstrate circumstances for which a slight deviation from UDITPA could be argued. The Division asserted that allowing such deviations would result in Utah's corporate franchise tax becoming difficult to administer. It further stated that, historically, deviations have only been allowed for specific industries whose circumstances are unique (e.g., film industry, financial institutions) and not for individual taxpayers.

29. The Division further argued that PETITIONER circumstances are not unique because retail companies frequently open new stores and new markets and that such circumstances do not warrant adjustments to UDITPA.

30. RESPONDENT REP 2 testified on behalf of the Division. RESPONDENT REP 2 is the Director of Policy Research at the Multistate Tax Commission ("MTC") and holds a doctorate in



economics. The Commission recognized RESPONDENT REP 2 as an expert witness in economics with expertise in tax and public finance.

31. RESPONDENT REP 2 testified that he was familiar with UDITPA and regression models of the type that PETITIONER submitted. He further stated that he had reviewed PETITIONER Tax Model. RESPONDENT REP 2 testified that in his opinion, PETITIONER Tax Model was not valid for a number of reasons. He also testified that Utah's UDITPA methodology fairly represents PETITIONER "business activity" in Utah for the years at issue.

32. RESPONDENT REP 2 not only explained his concerns with PETITIONER Tax Model at the hearing, but also in memoranda to the Division dated February 18, 2008 (Exhibit R-2) and July 19, 2007 (Exhibit R-3). In the February 18, 2008 memorandum, RESPONDENT REP 2 explained that "it appears that two of the explanatory variables [used in the Tax Model] – sales and payroll – are highly correlated. The high degree of correlation between these two variables casts doubt about the reliability of the estimates of the regression coefficients" (Exhibit R-2 at p. 2). At the hearing, RESPONDENT REP 2 further explained that such highly related variables should not have been used as *independent* variables.

33. RESPONDENT REP 2 further indicated in his memorandum that "[a] possible reason for the negative regression coefficients for payroll and property . . . is the presence of multicollinearity among the independent (explanatory) variables" (Exhibit R-2 at p.2). Although RESPONDENT REP 2 acknowledged that the Variable Inflation Factor that PETITIONER calculated for the Tax Model is less than 10, which would indicate no multicollinearity, he explained that it is "not proof of the absence of collinearity" (Exhibit R-2 at p.3).

34. At the hearing, RESPONDENT REP 2 further explained that PETITIONER Tax Model was based on "step-wise regression." RESPONDENT REP 2 testified that PERSON B, Professor of Economics and Statistics at ( X ), has advised to avoid step-wise regression because of the potential of biased results.

35. In his memorandum, RESPONDENT REP 2 also indicated that “[a]side from the econometric problems of this model, application of the results of PETITIONER model to PETITIONER apportionment factors yields inequitable results.” RESPONDENT REP 2 wrote that applying negative coefficients to the payroll and property factors “is tantamount to applying a tax to PETITIONER Utah sales and rebating part of the tax collection based on PETITIONER Utah payroll and property apportionment factors” (Exhibit R-2 at p. 3). At the hearing, RESPONDENT REP 2 testified that the effect of the Tax Model, which would rebate a portion of the tax on sales, is outside the realm of his state corporate franchise tax experience.

36. RESPONDENT REP 2 also concluded in his memorandum that “PETITIONER has not demonstrated that the standard three factor apportionment formula significantly distorts apportioned income” (Exhibit R-2 at p.3). Furthermore, RESPONDENT REP 2 testified that the R-square of XXXXX that PETITIONER determined for the UDITPA methodology is a “valid result,” showing that UDITPA is a reasonable approach to apportion PETITIONER income. He also testified that even if the Tax Model did not have the shortcomings he described, it would still be his opinion that UDITPA should be used to apportion PETITIONER income.

37. RESPONDENT REP 2 further testified that adjustments to UDITPA should be used rarely and in unusual circumstances. RESPONDENT REP 2 acknowledged, however, that the Executive Director of the MTC advocates more frequent consideration of alternative apportionment than he does. RESPONDENT REP 2 also acknowledged that PETITIONER new Utah market may not have been profitable at first. Nevertheless, he stated that such circumstances should not give rise to adjustments because UDITPA apportions income, including losses, to all states and does not pinpoint where the income is earned. He further stated that UDITPA’s combined reporting is preferable because it is easy to distort profits earned in any one location through separate accounting.

38. RESPONDENT REP 3 also testified on behalf of the Division. RESPONDENT REP 3 is the Division's Corporate Franchise Tax Audit Manager.

39. RESPONDENT REP 3 expressed concerns over PETITIONER allocation of e-commerce sales to its sales factor and its allocation of corporate and distribution center payroll and property to its respective payroll and property factors. RESPONDENT REP 3 testified that such allocations are not usually made under UDITPA and that it is hard to justify payroll and property located outside of Utah being added to the Utah factors. He also expressed his concern that PETITIONER Tax Model shows payroll and property to have a negative impact on profit.

40. RESPONDENT REP 3 also testified that Section 59-7-320 adjustments are usually associated with unique industries and should rarely be applied. He testified that the Division rarely grants requests for UDITPA adjustments for individual entities. Although RESPONDENT REP 3 admitted that PETITIONER Utah operations would probably be less profitable than its other stores for the years at issue, he maintained that such circumstances should not give rise to adjustments if UDITPA results in a fair and reasonable allocation of income.

41. In addition, RESPONDENT REP 3 testified that PETITIONER personnel told him that PETITIONER had requested or received approval for separate accounting from four other states, specifically STATE 1, STATE 2, STATE 3 and STATE 4. RESPONDENT REP 3 testified that the Division contacted these states and discovered that STATE 1 and STATE 2 had issued letters denying PETITIONER requests for separate accounting (Exhibits R-4 and R-5). RESPONDENT REP 3 also testified that STATE 3 informed the Division that it had not received a request from PETITIONER. Lastly, RESPONDENT REP 3 testified that STATE 4 had denied PETITIONER initial request, but had not yet acted on a second request.

42. RESPONDENT REP 3 admitted that the UDITPA provisions of the various states are less consistent than they had been in the past. He noted that many states, including Utah, now provide a taxpayer the opportunity to double-count the sales factor.

APPLICABLE LAW

1. Utah's UDITPA provisions are set forth in Title 59, Chapter 7, Part 3 of the Utah Code. Utah Code Ann. §59-7-303(1) (2006)<sup>7</sup> provides that "[a]ny taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its adjusted income as provided in this part."

2. UCA §59-7-311 provides the method by which business income is to be apportioned, as follows:

- (1) All business income shall be apportioned to this state by multiplying the business income by a fraction calculated as provided in Subsection (2).
- (2) The fraction described in Subsection (1) is calculated as follows:
  - (a) for a taxpayer that does not make an election authorized by Subsection (3):
    - (i) the numerator of the fraction is the sum of:
      - (A) the property factor as calculated under Section 59-7-312;
      - (B) the payroll factor as calculated under Section 59-7-315; and
      - (C) the sales factor as calculated under Section 59-7-317; and
    - (ii) the denominator of the fraction is three; and
  - (b) for a taxpayer that makes an election authorized by Subsection (3):
    - (i) the numerator of the fraction is the sum of:
      - (A) the property factor as calculated under Section 59-7-312;
      - (B) the payroll factor as calculated under Section 59-7-315; and
      - (C) the product of:
        - (I) the sales factor as calculated under Section 59-7-317; and
        - (II) two; and
    - (ii) the denominator of the fraction is four.
- (3) (a) For purposes of Subsection (2) and subject to Subsection (3)(b), for taxable years beginning on or after January 1, 2006, a taxpayer may elect to calculate the fraction for apportioning business income under this section in accordance with Subsection (2)(b).

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<sup>7</sup> The 2006 version of Utah law is cited in this decision. Although the cited statutes were revised in 2004 and 2005, the revisions have no effect on the Commission's decision in this case.

(b) If a taxpayer makes the election described in Subsection (3)(a), the taxpayer may not revoke the election for a period of five taxable years.

(c) In accordance with Title 63, Chapter 46a, Utah Administrative Rulemaking Act, the commission may make rules providing procedures for a taxpayer to make the election described in Subsection (3)(a).

3. UCA §59-7-320 provides for the equitable adjustment of the standard allocation or apportionment method, as follows:

Notwithstanding any other provision of this part, if the allocation and apportionment provisions of this part do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commission may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of any one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

#### DISCUSSION

The parties agree that Utah's UDITPA formula is appropriate in most instances to apportion an entity's unitary business income. In this instance, however, PETITIONER asserts that its profits in Utah for the three years at issue are lower than its profits for other stores because Utah was a new market that experienced pre-opening expenses and lower sales. As a result, PETITIONER asserts that an adjustment to UDITPA is required to fairly allocate its income to Utah. Adjustments to UDITPA are authorized under Section 59-7-320, which provides for adjustment "if the allocation and apportionment provisions . . . do not fairly represent the extent of the taxpayer's business activity in this state." The Commission will address the arguments that PETITIONER made and the evidence it submitted in support of its proposed UDITPA adjustments.

First, PETITIONER analogized the UDITPA methodology to mass appraisal values produced for property tax purposes. A property owner may successfully challenge a property value derived with mass

appraisal techniques by producing “better” evidence of value. PETITIONER argued that a corporate franchise taxpayer should, similarly, be able to successfully challenge the amount of business income apportioned under UDITPA by producing a method that “better” apportions income. The Commission does not find this argument convincing.

Under Utah law, property is taxed on the basis of its “fair market value,” not specifically on the basis of a mass appraisal formula (Utah Code Ann. §59-2-103(1)). Accordingly, a property value determined by mass appraisal may be successfully challenged by evidence that better reflects “fair market value.” On the other hand, Utah law specifically provides that a corporate franchise taxpayer’s business income shall be allocated and apportioned pursuant to UDITPA as long as it “fairly represents the extent of the taxpayer’s business activity in this state” (Sections 59-7-303(1) and 59-7-320). Accordingly, if the income allocated and apportioned under UDITPA fairly represents the taxpayer’s business activity in Utah, evidence of a “better” allocation and apportionment formula does not require the abandonment of or an adjustment to the UDITPA methodology. Such adjustments are necessary only if UDITPA does not fairly represent the taxpayer’s business activity in Utah.

Furthermore, whereas successful challenges of property tax values are common, adjustments to the UDITPA methodology are rare. Both RESPONDENT REP 2 and RESPONDENT REP 3 testified that alternative apportionment should rarely be used, which appears to be supported by PERSON C, one of the original proponents of UDITPA. In the article the taxpayer submitted subsequent to the hearing, PERSON C indicated that UDITPA includes a section that:

permits the tax administrator to require, or the taxpayer to petition, for some other method of allocating and apportioning the income where unreasonable results ensue from the operation of the other provisions of the act. This section necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be attacked on constitutional grounds. Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could

be achieved. **Of course, departures from the basic formula should be avoided except where reasonableness requires** (emphasis added).<sup>8</sup>

Concerning the validity of any apportionment formula, PERSON C further indicated that “a reading of the Supreme Court decisions indicates that it is extremely difficult for any taxpayer to show that the use of a formula causes an arbitrary and unreasonable levy in relation to local business activity.”<sup>9</sup>

Second, the Commission is not convinced that PETITIONER Tax Model is correct. RESPONDENT REP 2 was the only witness to testify who is an expert in economics. RESPONDENT REP 2 described, in depth, a number of econometric concerns and problems associated with the Tax Model that cause the Commission to question the validity of the model. PETITIONER did not present any evidence or expert testimony to allay these concerns. In addition, the Commission is concerned that the factors that PETITIONER developed and applied to the Tax Model weighting coefficients incorporate e-commerce sales that occurred outside of Utah and payroll and property from its corporate headquarter and distribution centers that are located outside of Utah.

Furthermore, even if sales, payroll and property factors determined under UDIPTA were applied to the Tax Model weighting coefficients, the Commission would still find PETITIONER proposed adjustments unconvincing. The Commission finds the Tax Model weighting coefficients to be suspect, finding it difficult to understand how payroll and property have a negative impact on “profits.” Moreover, Section 59-7-303(1) and Section 59-7-320 both focus on an entity’s “business activities” in Utah, not on the “profits” it earns in the state. The existence of payroll and property in a state is, without question, indicative of business activities in a state. Applying a negative coefficient to these factors would suggest that payroll and property reduces an entity’s business activities, which is illogical. For these reasons, the Commission agrees with

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<sup>8</sup> ( X ), *The Uniform Division of Income for State Tax Purposes*, TAXES The Tax Magazine, October 1957 at p. 781.

<sup>9</sup> *Id.* at p. 748.

RESPONDENT REP 2 that the Tax Model's weighting factors produce inequitable results and that the Tax Model is not convincing.

Third, even if the Tax Model were correct, the Commission does not believe that it demonstrates that UDITPA "unfairly" or "unreasonably" represented PETITIONER business activity in Utah for the three years at issue. RESPONDENT REP 2 testified that the R-square of XXXXX that PETITIONER calculated for UDITPA is high and shows that UDITPA is a reasonable and valid method to apportion PETITIONER income. PETITIONER did not refute RESPONDENT REP 2's observation other than to argue that the Tax Model should be preferred because it has a higher R-square.

Furthermore, the Commission notes that the amounts of "operating profits" earned and the sales made by PETITIONER Utah stores, as set forth in Exhibit P-3, do not appear abnormally low when compared to PETITIONER other stores. The Commission also notes that during the three years at issue, PETITIONER entered into seven new markets, which would suggest that PETITIONER total business income is impacted by start-up stores in states other than Utah (Exhibit R-6). Moreover, for a unitary business such as PETITIONER, UDITPA provides that any losses incurred by PETITIONER start-up stores in other states subsequent to the years at issue will have the effect of reducing PETITIONER Utah tax liability for these subsequent years.

In addition, PETITIONER business activities in Utah (i.e., the operation of department stores) appear to be similar, if not identical, to its unitary business activities in other states. The taxpayer's argument that Utah's UDITPA methodology should be adjusted because its Utah operations are less profitable for the years at issue is invalid unless it proves "by 'clear and cogent evidence' that the income attributed to the State is, in fact, 'out of all appropriate proportions to the business transacted . . . in that State' . . . or has 'led to a grossly distorted result.'" *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983) (quoting *Moorman Mfg.*



*Co. v. Bair*, 437 U.S. 267 (1978)). In *Container*, the United States Supreme Court denied the taxpayer's request for adjustments to UDITPA, stating:

[A]ppellant argues that its foreign subsidiaries are significantly more profitable than it is, and that the three-factor formula, by ignoring that fact and relying instead on indirect measures of income such as payroll, property, and sales, systematically distorts the true allocation of income between appellant and the subsidiaries. The problem with this argument is obvious: the profit figures relied on by appellant are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place.

...

[S]eparate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required. . . .

Furthermore, in *Western Contracting Corp. v. State Tax Commission*, 18 Utah 2d 23, 414 P.2d 579 (Utah 1966), the Utah Supreme Court found that for a unitary business, the proportion of net income to be allocated to Utah must be determined by the UDITPA formula "unless the party opposing the application of such formula shall prove by clear and convincing evidence that the taxes so imposed are grossly disproportionate to the business conducted in this state. . . ."

Based on these decisions and the evidence submitted by the parties, the Commission finds that the lower relative amounts of profit that PETITIONER may have earned in Utah for the three years at issue is not so "grossly disproportionate" to its business activity in Utah to require adjustments to UDITPA's apportionment and allocation formula. Based on the circumstances in this case and the evidence and testimony submitted, PETITIONER has not met the very high standard required to prove the necessity of alternation apportionment.

#### CONCLUSIONS OF LAW

1. PETITIONER operations in Utah are part of its unitary business, and it has income from business activity that is taxable both within and without Utah.

2. Pursuant to Section 59-7-303(1), the Commission finds that PETITIONER income should be apportioned and allocated in accordance with Utah's UDITPA provisions, unless equitable adjustments, as described in Section 59-7-320, are shown to be necessary.

3. The Commission finds that PETITIONER has not shown that Section 59-7-320 equitable adjustments are necessary in this case. In addition, the Commission finds that PETITIONER Tax Model is not convincing. Accordingly, the Commission rejects PETITIONER proposed Tax Model and denies its refund request for the 2004, 2005 and 2006 tax years.

DECISION AND ORDER

Based upon the foregoing, the Commission denies PETITIONER refund request. It is so ordered.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2008.

\_\_\_\_\_  
Kerry R. Chapman  
Administrative Law Judge

Appeal No. 05-1126

BY ORDER OF THE UTAH STATE TAX COMMISSION.

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2008.

Pam Hendrickson  
Commission Chair

R. Bruce Johnson  
Commissioner

Marc B. Johnson  
Commissioner

D'Arcy Dixon Pignanelli  
Commissioner

**NOTICE OF APPEAL RIGHTS:** You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. §63-46b-13. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Ann. §§59-1-601 and 63-46b-13 et. seq. Failure to pay any remaining balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.

*KRC/05-1126.fof*